

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF AIRVIEW ESTATES,)	
INC. FOR AN ADJUSTMENT OF RATES)	CASE NO.
PURSUANT TO THE ALTERNATIVE RATE)	93-007
FILING PROCEDURE FOR SMALL UTILITIES)	

O R D E R

On January 4, 1993, Airview Estates, Inc. ("Airview") filed its application for Commission approval to increase its sewer rates. Commission Staff, having performed a limited financial review of Airview's operations, has prepared the attached Staff Report containing Staff's findings and recommendations regarding the proposed rates. All parties should review the report carefully and provide any written comments or requests for a hearing or informal conference no later than 15 days from the date of this Order.


IT IS THEREFORE ORDERED that all parties shall have 15 days from the date of this Order to provide written comments regarding the attached Staff Report or requests for a hearing or informal conference. If no request for a hearing or informal conference is received, then this case will be submitted to the Commission for a decision.

Done at Frankfort, Kentucky, this 23rd day of June, 1993.

PUBLIC SERVICE COMMISSION


For the Commission

ATTEST:


Executive Director

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF AIRVIEW)	
ESTATES, INC. FOR A RATE)	CASE NO.
ADJUSTMENT PURSUANT TO THE)	93-007
ALTERNATIVE RATE FILING)	
PROCEDURE FOR SMALL UTILITIES)	

STAFF REPORT

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STAFF REPORT
ON
AIRVIEW ESTATES, INC.
CASE NO. 93-007

A. Preface

On January 4, 1993, Airview Estates, Inc. ("Airview") submitted its application seeking to increase its rates pursuant to the Alternative Rate Filing Procedure for Small Utilities ("ARF"). However, the application was not considered filed until January 15, 1993.

Airview is under order of the Franklin Circuit Court¹ to remove sludge deposits from a lagoon associated with the operation of the treatment plant. To carry out this directive, Airview agreed to file a rate application with the Commission requesting a rate increase to be in effect for 1 year to fund the costs associated with removing the sludge deposits from the lagoon. Airview's proposed rates would generate an increase in annual operating revenue of \$56,740, an increase of 150.6 percent over normalized test-period operating revenues of \$37,680.

To evaluate the requested increase, the Commission Staff ("Staff") chose to perform a limited financial review of Airview's operations for the test-period. However, Airview did not propose a test-period or include an income statement in its application. In accordance with 807 KAR 5:076 Section 1, utilities filing an ARF

¹ Commonwealth of Kentucky, Natural Resources and Environmental Protection Cabinet vs. Airview Estates, Inc. and Fred Schlatter, Franklin Circuit Court Civil Action No. 89-CI-1206.

application are to use the Annual Report for the immediate past year as the test period. At the time its application was filed, Airview's 1992 Annual Report had not been received by the Commission. Therefore, the test period in this proceeding is the calendar year ending December 31, 1991.

Mark Frost of the Commission's Division of Financial Analysis performed the limited review on April 21, 1993. Mr. Frost is responsible for the preparation of this Staff Report except for Section B, Normalized Operating Revenue; Section E, Rate Design; and Appendix A, which were prepared by John Geoghegan of the Commission's Division of Rates and Research. Based on the findings contained in this report, Staff recommends that Airview reduce its normalized operating revenues of \$37,680 by \$12,551.

Scope

The scope of the review was limited to obtaining information as to whether the test period operating revenues and expenses were representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

B. Analysis of Operating Revenues and Expenses

Normalized Operating Revenues

Airview's 1991 Annual Report indicates it had annual revenues from rates of \$27,050. A rate increase was granted to Airview

during the test year which generated an additional \$10,630 in revenue yielding a normalized revenue figure of \$37,680.²

Operating Expenses

In its 1991 Annual Report, Airview reported operating expenses of \$32,523. The following are Staff's recommended adjustments to Airview's test-period operations:

Owner/Manager Fee: Airview did not incur an owner/manager fee during the test-period. It has been the Commission's past practice to allow utilities of Airview's size an owner/manager fee of \$2,400. In Case No. 91-104, the Commission determined that Airview was entitled to an owner/manager fee of \$2,400.

During the test period, the Natural Resources and Environmental Protection Cabinet ("Natural Resources") cited Airview for various treatment plant violations. These treatment plant violations demonstrate that Fred Schlatter, President and sole stockholder of Airview, neglected his owner/manager duties by not supervising the daily operations of the treatment plant. As further evidence of this neglect, Staff made several attempts by telephone and certified letter to schedule its field review, but was unable to contact either Mr. Schlatter or an Airview representative.

² Case No. 91-104, The Application of Airview Estates, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities, Order issued on September 4, 1991.

Given Mr. Schlatter's neglect of his owner/manager duties, Staff is of the opinion that in this instance Airview is not entitled to an owner/manager fee. Therefore, Staff recommends that Airview's test-period operations not be adjusted to include an owner/manager fee.

Sludge Hauling: Airview reported sludge hauling expense of \$70 for the test period. A detailed review of the invoices and canceled checks shows that Airview paid Jack Payton \$150 in the test period for sludge removal. Accordingly, sludge hauling expense has been increased by \$80.

Electric: Airview reported electric expense for the test period of \$4,018. Upon review of the invoices, Staff determined that the actual electric expense was \$4,140, a difference of \$122 above the amount Airview reported. Accordingly, electric expense has been increased by \$122.

Collection Fee: Airview reported collection expense of \$2,278 for the test period. Airview's customer billing and collection is performed by Hardin County Water District No. 2 ("Hardin No. 2") at a rate of \$1 per customer. Based on the number of customers used to calculate normalized operating revenue, Airview's collection expense would be \$2,400,³ a difference of \$122 above the amount Airview reported. Accordingly, collection fee expense has been increased by \$122.

³ 200 Customers x 12-Months x \$1 Collection Fee = \$2,400.

Bookkeeping: In 1990 Airview paid its bookkeeper/secretary an annual fee of \$600, which was determined reasonable in Case No. 91-104. In the test period Airview paid its bookkeeper/secretary a fee of \$6,600, an increase of 1000 percent above the level determined reasonable in Case No 91-104.

Staff requested Airview to provide a schedule of its employees that included job duties, length of employment, test-period salary, and current salary. Airview provided Staff with a listing of its "non-employees/contractors", the length of employment, and the amounts it paid to each in 1990, 1991, and 1992. A position title was listed for each "non-employee/contractor" but a description of the duties performed was not included.

Given that Airview's billing and collection is performed by Hardin No.2 and the small number of checks written in the test-period, Staff is of the opinion that an annual fee of \$6,600 is excessive. Airview also failed to provide documentation to show that its test-period bookkeeper/secretary fee is reasonable. Therefore, Staff recommends bookkeeping/secretary fee expense be reduced by \$6,000 to the level determined reasonable in Case No. 91-104.

Accounting Fees: Airview did not report an accounting fee expense in its test-period operations. However, Weinberg O'Koon and Company ("Weinberg") prepared Airview's 1990 Annual Report, tax returns, and property returns for a fee of \$1,153, which the Commission determined reasonable in Case No. 91-104.

Staff is of the opinion that the accounting fee expense is an ongoing expenditure that should be reflected in test-period operations and that the level included in Airview's operations in Case No. 91-104 is reasonable. Therefore, accounting fee expense of \$1,153 has been included in test-period operations.

Regulatory Commission: Airview reported regulatory commission expense of \$2,230 for the test period. Included in that amount were payments of \$1,460 in fines and penalties assessed by Natural Resources for various violations at the sewage treatment plant.

It is the owner/manager's responsibility to insure that Airview's treatment plant is operated and conforms to the appropriate regulatory guidelines. Any fine or penalty assessed due to Airview's failure to meet any established guideline should be borne by the owner/manager and not Airview's customers. Therefore, Staff recommends that Airview's fines and penalties of \$1,460 be excluded for rate-making purposes.

The remaining \$770 of regulatory commission expense represented Airview's cost to file Case No. 91-104. Upon review of the Staff Report in Case No. 91-104, Staff noted that Airview was allowed to amortize its rate case cost over a 3-year period. Given that the cost of Case No. 91-104 will be fully amortized at the close of 1993, Staff is of the opinion that it does not reflect an on-going expenditure and should not be included in adjusted test period operations. Accordingly, the remaining regulatory

commission expense of \$770 should be eliminated from adjusted test period operations.

Legal Fees: Airview reported legal fee expense of \$2,850 for the test period. As previously mentioned, Airview was cited by Natural Resources for various violations at its treatment plant and ultimately was assessed \$1,460 in fines and penalties. The test-period legal fees were incurred by Airview due to the legal action taken by Natural Resources.

As with fines and penalties, any legal fee incurred due to Airview's failure to meet any established guideline should be borne by the owner/manager and not Airview's customers. Therefore, Staff recommends that Airview's legal fee expense of \$2,850 be eliminated from test-period operations.

Transportation: Airview reported test-period transportation expense of \$1,473. Upon review of the test-period invoices, Staff noted that the following expenditures were non-recurring in nature:

Truck Tires	\$ 521
Valve Covers	\$ 108
Installed Used Rear End	\$ 743

After consulting with the Commission's Engineering Division ("Engineering"), it was determined that the above expenditures should be amortized over 3 years. Therefore, Staff recommends that transportation expense be decreased by \$1,372 and amortization expense of \$458 be included in test-period operations.

Taxes Other Than Income: Airview reported taxes other than income expense of \$1,344 for the test period. Upon review of the

test period invoices, Staff determined that the actual taxes other than income expense was \$487,⁴ a difference of \$857 below the amount reported. Accordingly taxes other than income expense has been reduced by \$857.

Income Tax: Airview reported a test-period income tax expense credit of \$382. Based on Staff's recommended adjustments to operating revenues and expenses, Airview's pro forma income tax expense would be \$2,971,⁵ a difference of \$3,353 above the amount reported. Accordingly, income tax expense has been increased by \$3,353.

Operations Summary

Based on the recommendations of Staff contained in this report, Airview's pro forma operating statement would appear as set forth in Appendix B to this report.

C. Revenue Requirements Determination

In Case No. 91-104, the Commission used an 88 percent operating ratio to arrive at Airview's revenue requirement. This

⁴	Change of Address Fee	\$ 10
	Filing Fee - Secretary of State	55
	Filing Fee - Clerk	6
	PSC Assessment	50
	Property Tax	72
	County Property Tax	135
	License Fee	159
	Total	<u>\$ 487</u>
⁵	Operating Revenues	\$ 37,680
	Adjusted Operating Expenses	- 21,531
	Net Income Before Income Taxes	\$ 16,149
	Composite Tax Rate	x 18.40%
	Pro Forma Income Tax Exp.	<u>\$ 2,971</u>

approach is used primarily when there is no basis for rate-of-return determination or the cost of the utility plant has fully or largely been recovered through the receipt of contributions. Staff recommends that the operating ratio method be used in this proceeding.

Staff's adjusted operations provide Airview with an operating ratio of 57.14 percent.⁶ Staff is of the opinion that an 88 percent operating ratio would allow Airview sufficient revenues to cover its operating expenses and to provide for equity growth. In this proceeding, an operating ratio of 88 percent and an allowance for the appropriate state and federal income taxes results in a

⁶	Adjusted Operating Expenses	\$	24,502
	Income Tax Expense	-	2,971
	Adj. Operating Exp. Net of Income Tax	\$	<u>21,531</u>
	$\$21,531 + \$37,680 = 57.14\%$		

revenue requirement of \$25,129.⁷ Therefore, Staff recommends that Airview decrease its annual operating revenues by \$12,551.⁸

D. Surcharge

As previously mentioned, Airview is seeking Commission approval of a rate increase to fund the cost of removing the sludge deposits from the lagoon. Airview has requested that its rates be increased by \$56,740.

Airview attached a bid from B & H Septic Tank Service, Inc. ("B & H Septic") to support its estimated cost to clean the lagoon. Staff requested Airview to provide at least three comparable price quotes to show that the B & H Septic bid is reasonable. Airview averred that the companies it contacted either lacked the necessary equipment or were located too far from the treatment plant to be cost competitive, and therefore the companies did not provide bids.

⁷	Adjusted Operating Expenses*	\$ 21,531
	Recommended Operating Ratio	+ 88%
	Subtotal	\$ 24,467
	Adjusted Operating Expenses*	- 21,531
	Net Operating Income	\$ 2,936
	Income Tax Gross-Up Factor	x 1.2254902
	Net Operating Inc. Before Income Tax	\$ 3,598
	Adjusted Operating Expenses*	+ 21,531
	Recommended Revenue Requirement	<u>\$ 25,129</u>
	Recommended Revenue Requirement	\$ 25,129
	Adjusted Operating Expenses*	- 21,531
	Composite Tax Rate	x 18.40%
	Recommended Income Tax Expense	<u>\$ 662</u>
	* Net of Income Tax Expense	
⁸	Recommended Revenue Requirement	\$ 25,129
	Normalized Operating Revenue	- 37,680
	Recommended Revenue Decrease	<u>\$ <12,551></u>

Therefore, after consulting with Engineering, Staff determined that the bid from B & H Septic should be accepted as a reasonable estimate of the cost Airview will incur to clean the lagoon.

In its application Airview stated that it does not have the available funds and is unable to obtain any external financing to pay for this one-time expense. Airview added that the only means available to finance the lagoon cleaning is through a rate increase to be charged for a 1-year period.

Upon review of the test-period financial statements, Staff is in agreement with Airview regarding its internal funds and inability to obtain external financing. However, if Airview is granted a general rate increase to fund the lagoon cleaning, then the potential exists, once the lagoon has been cleaned, for Airview to earn in excess of the 88 percent operating ratio recommended herein. In order to fund the court ordered lagoon cleaning and to negate the possibility of future over-earning, Staff is of the opinion that Airview should be granted a monthly surcharge.

Given the impact a 1-year surcharge would have on the monthly bills of Airview's customers, and that the lagoon cleaning is a nonrecurring expenditure which would benefit future periods, it would be unfair to Airview's ratepayers to grant a surcharge for a short 1 year period. Staff is of the opinion and recommends that the surcharge be placed in effect for a 36-month period, or until

\$56,740 has been collected. This would result in monthly surcharge collections of \$1,576.⁹

If the surcharge is granted, the proceeds should be placed in a separate interest-bearing account. Monthly transfers to the surcharge account should equal the monthly surcharge recommended herein and should be transferred from Airview's gross operating revenues prior to those revenues being dispersed for another purpose. Airview should file monthly activity reports that contain the following information: the monthly surcharge billings and collections; the monthly bank statement; and payments from the account. Airview's failure to comply with the above funding requirements or to file the monthly reports should warrant the revocation of the surcharge and the refunding of the monies already collected, plus interest thereon.

The Commission should periodically inspect Airview's treatment plant to insure that the lagoon is cleaned. Airview's failure to clean its lagoon within 1 year from the date of a final Order should warrant the revocation of the surcharge and the refunding of the monies already collected plus interest.

The surcharge constitutes contributions, and should be accounted for in the manner prescribed by the Uniform System of Accounts for Class C Sewer Utilities. The monthly billing should be debited to customer accounts receivable and credited to the

⁹ $\$56,740 \div 36\text{-Months} = \$1,576.$


contributions account. When the amount is collected, special funds would be debited and customer accounts credited.


E. Rate Design

Surcharge Rate: Staff recommends implementing a monthly surcharge of \$7.90 over a period of 36 months to cover the costs associated with cleaning of the lagoon.¹⁰ The surcharge as set out in Appendix A is adequate to cover these costs.

Monthly Rate: Airview has proposed no change to its rate design. Staff is of the opinion that the current flat monthly rate design is appropriate for Airview. Therefore, any change in revenue will be added or subtracted to Airview's existing rate structure. Appendix A outlines the rates based on the decrease recommended herein.

F. Signatures


Prepared By: Mark C. Frost
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Water and Sewer Revenue
Requirements Branch
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Prepared By: John Geoghegan
Public Utility Rate
Analyst, Principal
Communications, Water and
Sewer Rate Design Branch
Rates and Research Division

¹⁰ Cost to Clean Lagoon
Amortization Period
Monthly Amortization
No. of Customers
Monthly Surcharge

\$ 56,740
+ 36-Months
\$ 1,576
+ 200
\$ 7.90

APPENDIX A
TO STAFF REPORT CASE NO. 93-007

The Staff recommends the following rate be prescribed for customers of Airview Estates, Inc.

Monthly Rate

\$10.47

Monthly Surcharge

\$7.90 for a period of 36 months or until \$56,740 has been collected.

APPENDIX B

TO THE STAFF REPORT IN CASE NO. 93-007

Staff's Recommended Pro Forma Operations

	<u>Actual Operations</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma Operations</u>
Operating Revenues:			
Residential - Flat Rate	\$ 27,050	\$ 10,630	\$ 37,680
Operating Expenses:			
Sludge Hauling	\$ 70	\$ 80	\$ 150
Water Expense	224	0	224
Testing Expense	2,100	0	2,100
Electric Expense	4,018	122	4,140
Chemical Expense	470	0	470
Routine Maintenance Fee	3,300	0	3,300
Maintenance:			
Treatment & Disposal	1,970	0	1,970
Other	1,000	0	1,000
Collection Expense	2,278	122	2,400
Bookkeeping Fees	6,600	< 6,000>	600
Office Supplies	16	0	16
Accounting Fees	0	1,153	1,153
Regulatory Expense	2,230	< 2,230>	0
Legal Fees	2,850	< 2,850>	0
Transportation	1,473	< 1,372>	101
Depreciation	2,962	0	2,962
Amortization	0	458	458
Taxes Other Than Income	1,344	< 857>	487
Income Tax Expense	< 382>	3,353	2,971
Total Operating Expenses	\$ 32,523	\$ < 8,021>	\$ 24,502
Net Operating Income	\$ < 5,473>	\$ 18,651	\$ 13,178

APPENDIX C

TO THE STAFF REPORT IN CASE NO. 93-007

Staff's Recommended Pro Forma Operations and Revenue Decrease

	<u>Pro Forma Operations</u>	<u>Recommended Decrease</u>	<u>Recommended Operations</u>
Operating Revenues:			
Residential - Flat Rate	\$ 37,680	\$ < 12,551>	\$ 25,129
Operating Expenses:			
Sludge Hauling	\$ 150	\$ 0	\$ 150
Water Expense	224	0	224
Testing Expense	2,100	0	2,100
Electric Expense	4,140	0	4,140
Chemical Expense	470	0	470
Routine Maintenance Fee	3,300	0	3,300
Maintenance:			
Treatment & Disposal	1,970	0	1,970
Other	1,000	0	1,000
Collection Expense	2,400	0	2,400
Bookkeeping Fees	600	0	600
Office Supplies	16	0	16
Accounting Fees	1,153	0	1,153
Regulatory Expense	0	0	0
Legal Fees	0	0	0
Transportation	101	0	101
Depreciation	2,962	0	2,962
Amortization	458	0	458
Taxes Other Than Income	487	0	487
Income Tax Expense	2,971	< 2,309>	662
Total Operating Expenses	\$ 24,502	\$ < 2,309>	\$ 22,193
Net Operating Income	\$ 13,178	\$ < 10,242>	\$ 2,936